Economic Outlook

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The approach of the New Year is an opportune time to consider the performance of the economy during the past 12 months and to assess its outlook from a broad perspective. At the beginning of 1985, forecasts of a recession in 1986 or sooner were widespread because of the serious problems facing the economy: sustained large Federal deficits that were perceived to limit the Federal Reserve's flexibility in attempting to prop up a faltering economy, high real interest rates, and an overvalued dollar. Today, however, the situation has improved dramatically. On a trade-weighted basis, the dollar has depreciated roughly 20% from the highs in early 1985. Interest rates have declined, while inflation has remained relatively subdued. The recent stock market rally has reflected the improved prospects for the economy as well as several other important developments, including a major change in OPEC's strategy and legislation that offers the promise of containing the Federal deficit.

A pickup in economic growth is likely to be evident in 1986, with continued expansion at least through 1987. Real gross national product is expected to rise 3.5% from the fourth quarter of 1985 to the fourth quarter of 1986, compared to an estimated increase of 2.6% in the current period. Because of the depreciation of the dollar, it is likely that inflation rates will be somewhat higher in 1986 than in 1985, offset partly by lower oil prices. The consumer price index is expected to rise 4.6% from December 1985 to December 1986, compared to an estimated rise of 3.8% from December 1984 to December 1985. The modest escalation of inflation and pickup in economic growth may well elicit a tightening in policy by the Federal Reserve, but the Fed would also be keenly aware of the strains this would cause less developed countries in servicing their substantial debt obligations.

If interest rates do rise at some point in 1986, interest-rate-sensitive industries, such as housing and autos, would likely be adversely affected. In view of the high levels of activity in these industries during the past few years, some weakness would be normal at this point in any case. Auto sales are expected to total 10.4 million units in 1986, equal to the 1984 level but down from the estimated 11.0 million units in 1985. Although auto sales will likely decline next year, the sales level would still be relatively high; the aging of the stock of cars in the United States indicates that potential replacement demand is still substantial. Housing starts are expected to total 1.64 million units next year, compared to an estimated total of 1.74 million in 1985 and 1.75 million in 1984.

In sum, the pieces are in place for a continued improvement in economic growth in the months ahead, from the sluggish pace of the first half of 1985. The U.S. industrial sector will likely experience somewhat faster growth next year as a result of the depreciation of the dollar and the progress in correcting inventory imbalances. Industrial production is expected to rise 3.5% in 1986, after rising an estimated 2.2% in 1985 and 11.5% in 1984. Corporate profits will likely show a considerable rebound next year, increasing about 10% (on an after-tax basis) after falling an estimated 2.7% in 1985. Nevertheless, many firms will continue to have to streamline operations to remain competitive with low-wage-cost imports.

Bernard Schoenfeld

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Economic Forecast

Percent Changes at Annual Rates

	Actual				Forecast				Actual	Forecast	
				1985				1986	1983-	1984-	1985-
	I	II	III	IV	I	II	III	IV	1984	1985	1986
Gross National Product	5.6	4.5	6.7	7.1	7.9	8.2	7.6	7.4	10.8	6.2	7.4
Real GNP	0.3	1.9	4.3	4.0	4.4	4.0	3.0	2.5	6.8	2.6	3.8
GNP Price Deflator	5.4	2.6	2.3	3.0	3.4	4.0	4.5	4.7	3.8	3.5	3.5

	Actual	Forecast	Actual	Forecast	
	1985:III	1985:IV	1983-1984	1984-1985	1985-1986
Consumer Spending	7.6%	4.6%	8.6%	7.3%	7.0%
Durable Goods	22.4	-15.8	13.9	7.7	2.6
Nondurable Goods	2.2	10.0	6.9	4.6	6.8
Services	7.6	7.1	8.5	9.1	8.4
Business Capital Spending	1.1	8.8	20.6	9.6	7.6
Structures	1.2	7.5	16.0	11.7	6.8
Equipment	1.1	9.6	23.4	8.4	8.0
Residential Investment	13.8	9.2	16.4	4.5	1.8
			1984	1985	1986
Change in Inventories	$-0.3b.	$18.0b.	$58.2b.	$19.1b.	$32.3b.
Net Exports of Goods and Services	$-104.0b.	$-100.0b.	$-64.2b.	$-93.1b.	$-95.5b.
			1983-1984	1984-1985	1985-1986
Government Purchases	20.4%	1.5%	9.0%	10.6%	7.4%
Federal	36.8	-8.4	9.5	13.2	5.1
Defense	25.1	4.0	10.5	11.5	8.4
Other	74.3	-36.0	6.7	18.5	-4.3
State & Local	10.3	9.0	8.7	8.8	8.9
Corporate Profits Before Tax	3.6*	5.1*	16.0	-2.8	9.9
Corporate Profits After Tax	2.1*	5.7*	14.5	-2.7	9.9
Plant and Equipment Expenditures	1.8	3.5	16.3	8.7	6.2
Real Final Sales#	5.8	2.1	5.0	3.6	3.4
Real Disposable Personal Income	-4.3	3.7	6.7	2.3	2.8

Economic Indicators	Recent Data			Actual	Forecast	
	Sept.	Oct.	Nov.	1983-1984	1984-1985	1985-1986
Consumer Price Index**	2.4%	2.4%	n.a.	4.0%	3.8%	4.6%
Producer Price Index for Finished Goods**	-7.2%	10.8	9.6%	1.7	1.9	3.5
Industrial Production	-0.1	-0.4	0.4	11.5	2.2	3.5
Retail Sales##	2.2	-4.2	1.1	10.5	6.4	5.2
				1984	1985	1986
Auto Sales (millions of units, a.r.)	14.4	9.6	9.8	10.4	11.0	10.4
Housing Starts (millions of units, a.r.)	1.75	1.58	n.a.	1.75	1.74	1.64
Unemployment Rate	7.1%	7.1%	7.0%	7.5%	7.2%	6.6%
Merchandise Trade Deficit (a.r.)	$186.6b.	$137.4b.	n.a.	$123.3b.	$147.0b.	$160.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

December 13, 1985

*GNP less change in inventories, both in real terms.
**Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).
$b. = billions a.r. = annual rate F = Forecast